US Daily: New Thinking on Fiscal Sustainability (Nicolae/Walker)

- Policymakers and economists have rethought old ideas about fiscal sustainability in recent years as interest rates have declined. In today's *Daily,* we recap a recent discussion of new approaches to assessing fiscal sustainability among leading macroeconomists.
- Many investors and policymakers are accustomed to thinking about fiscal sustainability in terms of the debt-to-GDP ratio, which will soon rise to the highest level in US history. In a recent study, Jason Furman and Lawrence Summers argue that a better measure of the debt burden is real interest expense as a share of GDP, which captures the cost of servicing the debt, adjusting for inflation. That measure is currently at a more historically normal level.
- Debt servicing costs are low at the moment in part because economic activity is still depressed and markets do not expect the Fed to normalize interest rates for a while. But even the further increases in yields that our interest rate strategists forecast would leave debt-servicing costs well within the normal historical range.
- The participants in the recent discussion identified two key risks to this mostly reassuring new view of fiscal sustainability. First, slowing the rise in debt servicing costs will likely require changes to entitlement spending, which under current law is projected to grow indefinitely as a share of GDP. Second, the neutral interest rate is quite uncertain in the long run, and a high debt-to-GDP ratio would amplify the fiscal cost of any surprise increase in interest rates.

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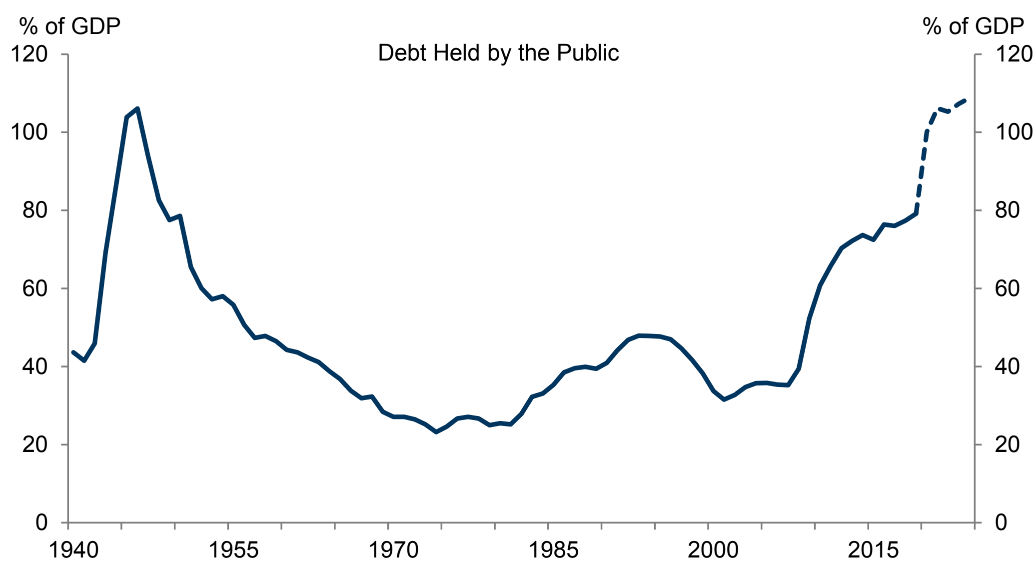
New Thinking on Fiscal Sustainability

Policymakers and economists have rethought old ideas about fiscal sustainability in recent years as interest rates have declined. In a recent discussion at the Brookings Institution, several leading macroeconomists—former Fed Chair Ben Bernanke, former IMF Chief Economists Olivier Blanchard and Ken Rogoff, former Council of Economic Advisers Chair Jason Furman, and former Treasury Secretary Lawrence Summers—debated new approaches to thinking about fiscal sustainability.[1] In today's *Daily*, we review these new perspectives on the costs and risks of higher debt.

Many investors and policymakers are accustomed to thinking about fiscal sustainability in terms of the ratio of the US federal debt to GDP. As Exhibit 1 shows, the debt-to-GDP ratio rose above 100% last year and will soon surpass the post-World War II peak to reach the highest level in US history. Viewed from this perspective, the current fiscal situation looks quite worrisome.

Exhibit 1: The US Debt-to-GDP Ratio Will Soon Reach the Highest Level in US History



Source: Office of Management and Budget, Goldman Sachs Global Investment Research

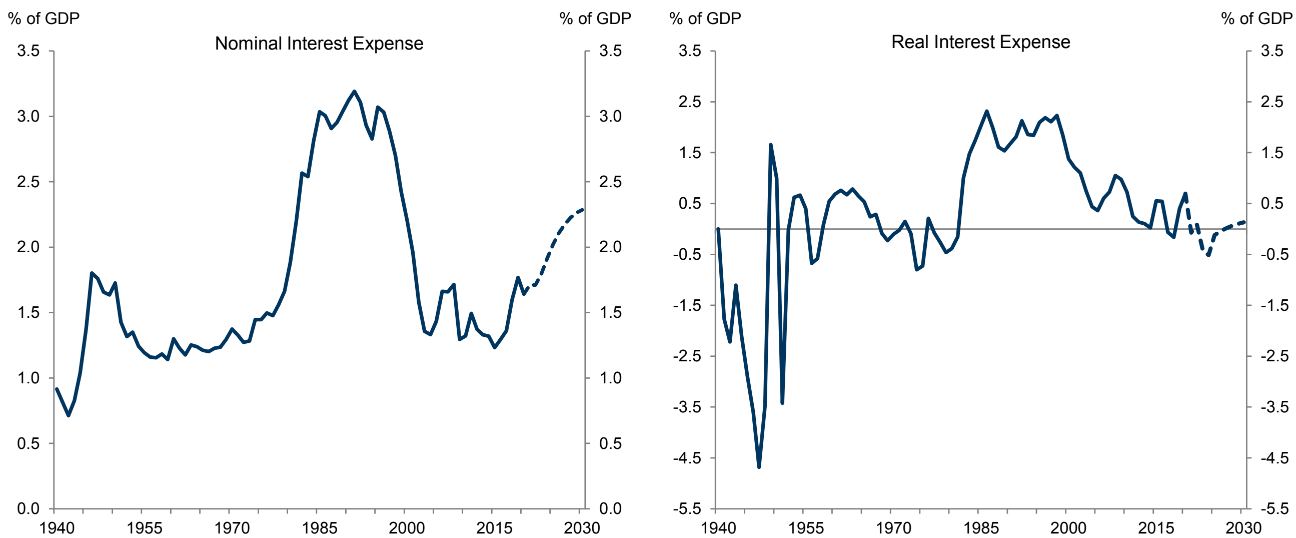
In a recent study, Furman and Summers argue that the debt-to-GDP ratio is a poor measure of the burden imposed by debt that exaggerates current fiscal risks.[2] They note that debt is a stock that can be repaid over time, while GDP is a flow for a single year. Dividing a stock by a flow in a single period ignores the future value of output. One could divide debt by another stock—the present value of all future output—but that is difficult to estimate and very sensitive to assumptions about future growth and interest rates.

[1] "Fiscal Policy Advice for Joe Biden and Congress," Brookings Institution Webinar, December 1, 2020.

[2] Jason Furman and Lawrence Summers, "A Reconsideration of Fiscal Policy in the Era of Low Interest Rates," 2020.

Instead, Furman and Summers argue, we should focus on the cost of servicing the debt as a share of GDP, which amounts to dividing a flow by a flow. A simple measure of this would be nominal interest expense as a share of nominal GDP, shown on the left of Exhibit 2, which captures the actual cash outflows required to maintain the current debt level in dollar terms. Furman and Summers recommend one further adjustment to better capture the true cost of bearing a given debt load: subtracting the stock of debt that is "inflated away" each year from the interest payments to account for the fact that inflation decreases the real value of the debt stock. This could be thought of as the net cash outflows required to maintain the current real value of the debt. This measure of real interest expense as a share of GDP is shown on the right of Exhibit 2.

Exhibit 2: Interest Expense as a Share of GDP, a Better Measure of the Debt Burden, Remains at a More Historically Normal Level



Source: Office of Management and Budget, Goldman Sachs Global Investment Research

These alternative measures give a very different perspective on fiscal sustainability than the debt-to-GDP ratio shown above, with both at historically normal or even low levels. The intuition is that while the level of the debt is historically high, average interest rates on Treasury debt are historically low, and multiplying them together implies roughly average interest expense as a share of GDP.

Of course, interest rates are low at the moment in part because the bond market judges that they will be low on average in the long run—that is, that the neutral rate or r* has declined significantly—but also in part because the economy is currently weak and the fed funds rate is at the effective lower bound and expected to stay low for a while. Our interest rate strategists expect yields to rise across the curve in coming years as the economy recovers quickly. Using their forecasts, we project how nominal and real interest expense as a share of GDP would evolve in the years ahead.

The dotted lines in Exhibit 2 show that the increase in interest rates we forecast would raise debt servicing costs over the next decade, but would still leave them within a normal historical range, assuming that the deficit eventually stabilizes. Specifically, we project that real interest expense will decline from less than 1% of GDP today to roughly 0% of GDP by 2030, assuming that the expansion continues until then and interest rates gradually normalize to the Fed's estimate of the neutral rate. It declines because debt issued at a higher interest rate in the past matures and is replaced by new debt issuance at lower interest rates; somewhat higher future inflation also partially offsets the projected rise in nominal interest rates.

As the participants in the recent discussion note, even from the perspective of this new approach to assessing fiscal sustainability, there are still two key risks to longer-term fiscal sustainability.

First, as Rogoff emphasizes in a recent paper, traditional debt statistics mostly ignore massive future entitlement obligations, such as Social Security and Medicare, which are on an upward trajectory.[3] Furman and Summers similarly note that their less concerned view of fiscal sustainability assumes that Social Security is reformed within the next 30 years, as scheduled under current law when the Social Security Administration's main trust fund is depleted.[4]

Second, the neutral interest rate is very difficult to predict in the longer run, and at more distant horizons it is therefore hard to know if interest rates will remain as low as they are today. Bernanke, Rogoff, and Blanchard argue that some potential structural changes—changing demographics, expanded social insurance and slower savings growth in emerging markets, or greater investment demand for green technology—could raise the neutral rate in the future. If so, a high debt-to-GDP ratio would amplify the impact of any surprise increase in interest rates on debt servicing costs as a share of GDP.

Even if the neutral rate rises, Summers argues that the federal government could raise taxes moderately to increase revenue by enough to meet the increase in interest expense. This is particularly true in the US because tax revenue is currently a smaller share of GDP than in most developed countries. The same is true of Japan, and this has been one factor that has reassured investors in its government debt, which is much larger as a share of GDP than in the US. Alternatively, the US could also reduce spending on health care — for which it spends a significantly larger share of GDP than most developed countries — to cover an increase in interest expense.

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[3] Kenneth Rogoff, "Falling Real Interest Rates, Rising Debt: A Free Lunch?" 2020. Rogoff argues that low market interest rates on advanced economy government debt reflect an assumption that governments would surely cut entitlement obligations, which are implicitly seen as "junior" debt, rather than default on "senior" sovereign debt obligations, but that this is less obvious than it appears.

[4] "Fiscal Policy Advice for Joe Biden and Congress."

Disclosure Appendix

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We, Jan Hatzius, Alec Phillips, David Mericle, Spencer Hill, CFA, Daan Struyven, Joseph Briggs, Blake Taylor, Ronnie Walker and Laura Nicolae, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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